FINANCIAL MANAGEMENT

LATEST CBSE QUESTIONS

Question 1.
What is meant by **'financial management'**? **(CBSE, Delhi 2017)**
Answer:
Financial Management is concerned with optimal procurement as well as usage of finance.

Question 2.
Somnath Ltd. is engaged in the business of export of garments. In the past, the performance of the company had been upto the expectations. In line with the latest technology, the company decided to upgrade its machinery. For this, the Finance Manager, Dalmia estimated the amount of funds required and the timings. This will help the company in linking the investment and the financing decisions on a continuous basis. Dalmia therefore, began with the preparation of a sales forecast for the next four years. Fie also collected the relevant data about the profit estimates in the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources of the business. For the remaining funds he is trying to find out alternative sources from outside. **(CBSE, Delhi 2017)**
Identify the financial concept discussed in the above para. Also state the objectives to be achieved by the use of financial concept, so identified.
Answer:
Financial planning is the financial concept discussed in the above paragraph. The process of estimating the fund requirements of a business and specifying the sources of funds is called financial planning. It relates to the preparation of a financial blueprint of an organisation's future operations. The objectives to be achieved by the use of financial concept are stated below:

- To ensure availability of funds whenever required which involves estimation of the funds required, the time at which these funds are to be made available and the sources of these funds.
- To see that the firm does not raise resources unnecessarily as excess funding is almost as bad as inadequate funding. Financial planning ensures that enough funds are available at right time.

Question 3.
Explain briefly any four factors which affect the choice of capital structure of a

company.
(CBSE, Delhi 2017)
Answer:
The four factors which affect the choice of capital structure of a company are described below:

- **Risk:** Financial risk refers to a situation when a company is unable to meet its fixed financial charges. Financial risk of the company increases with the higher use of debt. This is because issue of debt involves fixed commitment in terms of payment of interest and repayment of capital.
- **Flexibility:** Too much dependence on debt reduces the firm's ability to raise debt during unexpected situations. Therefore, it should maintain flexibility by not using debt to its full potential.
- **Interest Coverage ratio (ICR):** The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation. This may be calculated as follows:
  ICR = EBIT/Interest.
  If the ratio is higher, lower is the risk of company failing to meet its interest payment obligations hence debt may be issued or vice versa. But besides interest payment related repayment obligations should also be considered.
- **Cash flow position:** The issue of debt involves a fixed commitment in the form of payment of interest and repayment of capital. Therefore if the cash flow position of the company is weak it cannot meet the fixed obligations involved in issue of debt it is likely to issue equity or vice versa.

Question 4.
Explain briefly any four factors that affect the working capital requirement of a company.
(CBSE, Delhi 2017)
Answer:
The four factors that affect the working capital requirements of a company are explained below:

- **Credit availed:** In case the suppliers from whom the firm procures the raw material needed for production or finished goods follow a liberal credit policy, the business can be operated on minimum working capital or vice versa.

- **Credit allowed:** The credit terms may vary from firm to firm. However, if the level of competition is high or credit worthiness of its clients is good the firm is likely to follow a liberal credit policy and grant credit to its clients it results in higher amount of debtors, increasing the requirement of working capital or vice versa.
- **Scale of operations:** The amount of working capital required by a business varies directly in proportion to its scale of business. For organisations which operate on a higher scale of operation, the quantum of inventory, debtors required is generally high. Such organisations, therefore, require large amount of working capital as compared to the organisations which operate on a lower scale.
- **Growth prospects:** The business firms who wish to take advantage of a forthcoming business opportunity or plan to expand its operations will require higher amount of working capital so that is able to meet higher production and sales target whenever required or vice versa .

Question 5.
Explain briefly any four factors that affect the fixed capital requirements of a company.
(CBSE, Delhi 2017)
Answer:
The four factors that affect the fixed capital requirements of a company are explained below:

- **Nature of business:** The kind of activities a business is engaged in has an important bearing on its fixed capital requirements. On one hand a trading concern does not require to purchase plant and machinery etc. and needs lower investment in fixed assets. Whereas on the other hand a manufacturing organisation is likely to invest heavily in fixed assets like land, building, machinery and needs more fixed capital.
- **Scale of operations:** The amount of fixed capital required by a business varies directly in proportion to its scale of businessA larger organisation operating at a higher scale needs bigger plant, more space etc. and therefore, requires higher investment in fixed assets when compared with the small organisation.
- **Diversification:** If a business enterprise plans to diversify into new product lines, its requirement of fixed capital will increase as compared to an organisation which does not have any such plans.
- **Growth prospects:** If a business enterprise plans to expand its current business operations in the anticipation of higher demand, its

requirement of fixed capital will be more as compared to an organisation which doesn’t plan to persue any such plans.

Question 6.
What is meant by **‘Capital Structure’**? **(CBSE, OD 2017)**
Answer:
Capital structure refers to the mix between owned funds and borrowed funds.

Question 7.
Ramnath Ltd. is dealing in import of organic food items in bulk. The company sells the items in smaller quantities in attractive packages. Performance of the company has been up to the expectations in the past. Keeping up with the latest packaging technology, the company decided to upgrade its machinery. For this, the Finance Manager of the company, Mr. Vikrant Dhull, estimated the amount of funds required and the timings. This will help the company in linking the investment and the financing decisions on a continuous basis. Therefore, Mr. Vikrant Dhull began with the preparation of a sales forecast for the next four years. He also collected the relevant data about the profit estimates in the coming years. By doing this, he wanted to be sure about the availability of funds from the internal sources. For the remaining funds he is trying to find out alternative sources.
Identify the financial concept discussed in the above paragraph. Also, state any two points of importance of the financial concept, so identified. **(CBSE, OD 2017)**
Answer:

- Financial planning is the financial concept discussed in the above paragraph. The process of estimating the fund requirements of a business and specifying the sources of funds is called financial planning. It relates to the preparation of a financial blueprint of an organisation’s future operations.
- The two points highlighting the importance of planning are described below:
  - It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.
  - It helps in anticipating future requirements of a funds and evading business shocks and surprises .

Question 8.
When is financial leverage favourable? **(CBSE, Sample Paper 2017)**
Answer:

Financial leverage affects the profitability of a business and it is said to be favourable when return on investment (ROI) is higher than cost of Debt.

Question 9.
"A business that doesn't grow dies", says Mr. Shah, the owner of Shah Marble Ltd. with glorious 36 months of its grand success having a capital base of RS.80 crores. Within a short span of time, the company could generate cash flow which not only covered fixed cash payment obligations but also create sufficient buffer. The company is on the growth path and a new breed of consumers is eager to buy the Italian marble sold by Shah Marble Ltd. To meet the increasing demand, Mr. Shah decided to expand his business by acquiring a mine. This required an investment of RS.120 crores. To seek advice in this matter, he called his financial advisor Mr. Seth who advised him about the judicious mix of equity (40%) and Debt (60%). Mr. Seth also suggested him to take loan from a financial institution as the cost of raising funds from financial institutions is low. Though this will increase the financial risk but will also raise the return to equity shareholders. He also apprised him that issue of debt will not dilute the control of equity shareholders. At the same time, the interest on loan is a tax deductible expense for computation of tax liability. After due deliberations with Mr. Seth, Mr. Shah decided to raise funds from a financial institution.

- Identify and explain the concept of Financial Management as advised by Mr. Seth in the above situation.
- State the four factors affecting the concept as identified in part (1) above which have been discussed between Mr. Shah and Mr. Seth. **(CBSE,Sample Paper 2017)**

Answer:

- Capital structure is the concept of Financial Management as advised by Mr. Seth in the above situation. Capital structure refers to the mix between owners funds and borrowed funds.
- The four factors affecting capital structure which have been discussed between Mr. Shah and Mr. Seth are explained below:
  - **Cashflow position:** The issue of debt capital involves a fixed burden on the company in the form of payment of interest and repayment of capital. Therefore if the cash flow position of a company is good it may issue debt else equity to raise the required amount of capital.

- **Risk Consideration:** Financial risk refers to a situation when a company is unable to meet its fixed financial charges. Financial risk of the company increases with the higher use of debt. This is because issue of debt involves fixed commitment in terms of payment of interest and repayment of capital.
- **Tax rate:** Considering the fact that amount of interest paid is a deductible expense, cost of debt is affected by the tax rate. If for example a firm is borrowing @ 10% and the tax rate is 30%, the after tax cost of debt is only 7%. Therefore, when the tax rate is higher it makes debt relatively cheaper and increases its attraction vis-a-vis equity.
- **Control:** The issue of debentures doesn't affect the control of the equity shareholders over the business as the debenture holders do not have the right to participate in the management of the business.

Question 10.

Shalini, after acquiring a degree in Hotel Management and Business Administration, took over her family food processing company of manufacturing pickles, jams and squashes. The business had been established by her great grandmother and was doing reasonably well. However, the fixed operating costs of the business were high and the cash flow position was weak. She wanted to undertake modernisation of the existing business to introduce the latest manufacturing processes and diversify into the market of chocolates and candies. She was very enthusiastic and approached a finance consultant, who told her that approximately ? 50 lakh would be required for undertaking the modernisation and expansion programme. He also informed her that the stock market was going through a bullish phase.

- Keeping the above considerations in mind, name the source of finance Shalini should not choose for financing the modernisation and expansion of her food processing business. Give one reason in support of your answer.
- Explain any two other factors, apart from those stated in the above situation, which Shalini should keep in mind while taking this decision. **(CBSE, Sample Paper 2016)**

Answer:

- Shalini should not choose debt capital for financing the modernisation and expansion of her food processing business because the fixed operating cost of the company is high. It cannot take the additional burden of fixed commitments in terms of payment of interest and repayment of capital by issuing debt.
- The other two factors that Shalini must keep in mind while taking this decision are stated below:
  - **Risk:** Financial risk refers to a situation when a company is unable to meet its fixed financial charges. Financial risk of the company increases with the higher use of debt. This is because issue of debt involves fixed commitment in terms of payment of interest and repayment of capital.
  - **Flexibility:** Too much dependence on debt reduces the firm's ability to raise debt during unexpected situations. Therefore, it should maintain flexibility by not using debt to its full potential.

Question 11.
Radhika and Vani who are young fashion designers, left their job vyith a famous fashion designer chain to set-up a company 'Fashionate Pvt. Ltd.' They decided to run a boutique during the day and coaching classes for the entrance examination of National Institute of Fashion Designing in the evening. For the coaching centre, they hired the first floor of a nearby building. Their major expense was the money spent on photocopying of notes for their students. They thought of buying a photocopier knowing fully that their scale of operations was not sufficient to make full use of photocopier.
In the basement of the building of Fashionate Pvt. Ltd, Praveen and Ramesh were carrying on a printing and stationery business in the name of 'Neo Prints Pvt. Ltd.' Radhika approached Praveen with the proposal to buy a photocopier jointly which could be used by both of them without making separate investment. Praveen agreed to this.
Identify the factor affecting the fixed capital requirements of Fashionate Pvt. Ltd. **(CBSE, Delhi 2016)**
Answer:
The factor affecting the fixed capital requirement of Fashionable Pvt. Ltd. is the level of collaboration. This kind of arrangement of using the resources jointly helps to reduce the fixed capital requirements of the business firms.

Question 12.
Kay Ltd. is a company manufacturing textiles. It has a share capital of ? 60 lakhs. In the previous year, its earning per share was ? 0.50. For diversification, the company requires an additional capital of ? 40 lakhs. The

company raised funds by issuing 10% debentures for the same. During the year, the company earned a profit of ? 8 lakhs on the capital employed. It paid tax @ 40%.

- State whether the shareholders gained or lost, in respect of earning per share on diversification. Show your calculations clearly.
- Also state any three factors that favour the issue of debentures by the company as part of its capital structure. **(CBSE, OD 2016)**

OR

Vivo Ltd. is a company manufacturing textiles. It has a share capital of Rs. 60 lakhs. The earning per share in the previous year was Rs. 0.50. For diversification, the company requires an additional capital of Rs. 40 lakhs. The company raised funds by issuing 10% debentures for the same. During the current year, the company earned a profit of Rs. 8 lakhs on the capital employed. It paid tax @ 40%.

- State whether the shareholders gained a lost, in respect of earning per share on diversification. Show your calculations clearly.
- Also, state any three factors that favour the issue of debentures by the company as part of its capital structure. **(CBSE, Delhi 2016)**

Answer:

- Let us presume that the share capital of Rs. 60 lakh is made up of Rs. 6 lakh equity shares assuming that the face value of each share is Rs.10.

Sources	**Situation 1 (Amount (in Rs.))**	**Situation 2 (Amount (in Rs.))**
Equity shares	60,00,000	60,00,000
10 % Debentures	NIL	40,00,000

Total Capital	60,00,000	1,00,00,000
EBIT	—	8,00,000
Less: Interest	—	– (4,00,000)
EBT	—	4,00,000
Less: Tax @ 40%	—	– (1,60,000)
EAT	*3,00,000	2,40,000
No. of shares of Rs. 10 each	6,00,000	6,00,000
EPS	0.50	2,40,000/6,00,000 = 0.40

- *0.50 x 6,00,000 = 3,00,000

Consequently EBT/EBIT in situation 1 = Rs. 5,00,000
Thus, on diversification, the earning per share fell down from Rs. 0.50 to Rs. 0.40.

- The three factors that favor the issue of debentures by the company as part of its capital structure are as follows:
    - **Tax deductibility:** Debt is considered to be a relatively cheaper source of finance as the amount of interest paid on debt is treated as a tax deductible expense.

- **Flotation cost:** The money spent by the company on raising capital through debentures is less than that spent on equity.
- **Control:** The issue of debentures doesn’t affect the control of the equity shareholders over the business as the debenture holders do not have the right to participate in the management of the business.

Question 13.
Rizul Bhattacharya, after leaving his job, wanted to start a Private Limited Company with his son. His son was keen that the company may start manufacturing mobile-phones with some unique features. Rizul Bhattacharya felt that mobile phones are prone to quick obsolescence and a heavy fixed capital investment would be required regularly in this business. Therefore, he convinced his son to start a furniture business.
Identify the factor affecting fixed capital requirements which made Rizul Bhattacharya choose the furniture business over mobile phones. **(CBSE, OD 2016)**
Answer:
The factor affecting the fixed capital requirements which made Rizul Bhattacharya choose the furniture business over mobile phones is technological up gradation.

Question 14.
Tata International Ltd. earned a net profit of Rs. 50 crores. Ankit, the finance manager of Tata International Ltd. wants to decide how to appropriate these profits. Discuss any five factors which will help him in taking this decision. **(CBSE, Sample Paper, 2015)**
Answer:
The five factors which will help Ankit, in taking the dividend decision are described below:

- **Earnings:** Since the dividends are paid out of current and past earnings, there is a direct relationship between the amount of earnings of the company and the rate at which it declares dividend. If the earnings of the company are high, it may declare a higher dividend or vice-versa.
- **Cash flow position:** Since the dividends are paid in cash, if the cash flow position of the company is good it may declare higher dividend or vice-versa.
- **Access to capital market:** If the company enjoys an easy access to capital market because of its credit worthiness. It does not feel the need

to depend entirely on retained earnings to meet its financial needs. Hence, it may declare higher dividend or vice-versa.

- **Growth prospects:** If the company has any forthcoming investment opportunities, it may like to retain profits to finance its expansion projects. This is because retained profits is considered to be the cheapest source of finance as it doesn't involve any explicit costs. Hence, it may declare lower dividend or vice-versa.

- **Preferences of the shareholders:** The companies paying stable dividends are always preferred by small investors primarily if they want regular income in the form of 'stable returns' from their investments. Large shareholders may be willing to forgo their present dividend in pursuit of higher profits in future. Therefore, the preferences of the shareholders must be taken into consideration.

Question 15.

'Abhishek Ltd' is manufacturing cotton clothes. It has been consistently earning good profits for many years. This year too, it has been able to generate enough profits. There is availability of enough cash in the company and good prospects for growth in future. It is a well managed organisation and believes in quality, equal employment opportunities and good remuneration practices. It has many shareholders who prefer to receive a regular income from their investments.

It has taken a loan of Rs. 50 lakhs from ICICI Bank and is bound by certain restrictions on the payment of dividend according to the terms of the loan agreement.

The above discussion about the company leads to various factors which decide how much of the profits should be retained and how much has to be distributed by the company. Quoting the lines from the above discussion, identify and explain any four such factors. **(CBSE, 2015)**

Answer:

The five factors which Ankit has to consider before taking dividend decisions are:

- **Growth Opportunities:** Financial needs of a firm are directly related to the investment opportunities available to it. If a firm has abundant profitable investment opportunities, it will adopt a policy of distributing lower dividends. It would like to retain a large part of its earnings because it can reinvest them at a higher rate.

- **Stability of Dividends:** Investors always prefer a stable dividend policy. They expect to get a fixed amount as dividends which should increase gradually over the years.

- **Legal Restrictions:** A firm's dividend policy has to be formulated within the legal provisions and restrictions of the Indian Companies Act.
- **Restrictions in Loan Agreements:** Lenders, mostly financial institutions, put certain restrictions on the payment of dividends to safeguard their interests.
- **Liquidity:** The cash position is a significant factor in determining the size of dividends. Higher the cash and overall liquidity position of a firm, higher will be its ability to pay dividends.

Question 16.
Amit is running an 'advertising agency' and earning a lot by providing this service to big industries State whether the working capital requirement of the firm will be 'less' or 'more'. Give reason in support of your anser. **(CBSE, Sample Paper 2014-15)**
Answer:
The working capital requirements of Amit will be relatively less as he is running an advertising agency, wherein there is no need to maintain inventory.

Question 17.
Yogesh, a businessman, is engaged in the purchase and sale of ice-creams. Identify his working capital requirements by giving reasons to support your answer. Now, he is keen to start his own ice-cream factory. Explain any two factors that will affect his fixed capital requirements. **(CBSE, OD 2012)**
Answer:

- The working capital requirements of Yogesh will be less as he is engaged in trading business.
- The two factors that will affect his fixed capital requirements when he will start his own ice-cream factory are described below:
    - **Level of collaboration:** If Yogesh gets an opportunity to set up his factory in collaboration with another enterprise, his fixed capital requirements will reduce considerably else his fixed capital requirements will be more.
    - **Financial alternatives available:** If Yogesh is able to get the place to start the factory and machinery on lease, his fixed capital requirements will reduce considerably. Whereas if he decides to purchase them, his fixed capital requirements will be more.

Question 18.
Amar is doing his transport business in Delhi. His buses are generally used for

tourists going to Jaipur and Agra. Identify the working capital requirements of Amar. Give reasons to support your answer. Further, Amar wants to expand and diversify his transport business. Explain any two factors that will affect his fixed capital requirements. **(CBSE, OD, 2012)**

Answer:

- The working capital requirements of Amar will be relatively less as he is engaged in prtividing transport services wherein there is no need to maintain inventory.
- The factors affecting the fixed capital needs of his business are as follows:
  - **Diversification:** If a business enterprise plans to diversify into new product lines, its requirement of fixed capital will increase.
  - **Growth prospects:** If a business enterprise plans to expand its current business operations in the anticipation of higher demand, consequently, more fixed capital will be needed by it.

Question 19.

Manish is engaged in the business of manufacturing garments. Generally, he used to sell his garments in Delhi. Identify the working capital requirements of Manish giving reason in support of your answer. Further, Manish wants to expand and diversify his garments business. Explain any two factors that will affect his fixed capital requirements. **(CBSE, Delhi 2012)**

Answer:

- The working capital requirements of Manish will be relatively more as he is engaged in the business of manufacturing garments. This is because the length of production cycle is longer i.e. it takes time to convert raw material into finished goods.
- The factors affecting the fixed capital needs of his business are as follows:
  - **Scale of Operations:** The amount of fixed capital required by a business enterprise is directly proportionate to its scale of operations. Therefore, if Manish plans to do business on a large scale, his fixed capital requirements will be more or vice versa.
  - **Technological Upgradation:** If Manish plans to use machines of latest technology in manufacturing garments, his fixed capital requirements will be more as replacement of obsolete machines will require huge financial outlay.

Question 20.
Harish is engaged in the warehousing business and his warehouses are generally used by businessmen to store fruits. Identify the working capital requirements of Harish giving reasons in support of your answer. Further, Harish wants to expand and diversify his warehousing business. Explain any two factors that will affect his fixed capital requirements. **(CBSE, Delhi 2012)**
Answer:

- The working capital requirements of Harish will be relatively less as he is engaged in providing warehousing services wherein there is no need to maintain inventory.
- The factors affecting the fixed capital needs of his business are as follows:
  - **Diversification:** If a business enterprise plans to diversify into new product lines, its requirement of fixed capital will increase.
  - **Scale of Operations:** The amount of fixed capital required by a business enterprise is directly proportionate to its scale of operations. Therefore, if Harish plans to do business on a large scale his fixed capital requirements will be more or vice versa.

ADDITIONAL QUESTIONS

Question 1.
Arun is a successful businessman in the paper industry. During his recent visit to his friend's place in Mysore, he was fascinated by the exclusive variety of incense sticks available there. His friend tells him that Mysore region is known as a pioneer in the activity of Agarbathi manufacturing because it has a natural reserve of forest products especially Sandalwood to provide for the base material used in production. Moreover, the suppliers of other types of raw material needed for production follow a liberal credit policy and the time required to manufacture incense sticks is relatively less. Considering the various factors, Arun decides to venture into this line of business by setting up a manufacturing unit in Mysore.
In context of the above case:

- Identify and explain the type of financial decision taken by Arun.
- Identify the three factors mentioned in the paragraph which are likely to affect the working capital requirements of his business.

Answer:

- Investment decision has been taken by Arun. Investment decision seeks to determine as to how the firm's funds are invested in different assets. It helps to evaluate new investment proposals and select the best option on the basis of associated risk and return. Investment decision can be long term or short-term. A long-term investment decision is also called a Capital Budgeting decision
- The three factors mentioned in the paragraph which are likely to reduce the working
capital requirements of his business are as follows: .
  - **Availability of raw material:** As there is easy availability of Sandalwood which is used as the base material for production, the working capital requirements of his business will be less as there is no need to stock the raw materials.
  - **Production cycle:** The production cycle is shorter and less time is required to manu¬facture incense sticks. Thus, the working capital requirements of his business will be low.
  - **Credit availed:** Due to the fact that the suppliers of other types of raw material needed for production follow a liberal credit policy, the business can be operated on minimum working capital.

Question 2.
'Adwitiya' is a company enjoying market leadership in the food brands segment. It's portfolio includes three categories in the Foods business namely Snack Foods, Juices and Confectionery. Keeping in line with the growing demand for packaged food it now plans to introduce Ready- To-Eat Foods. Therefore, the company has planned to undertake investments of nearly Rs. 450 crores for its new line of business. As per the current financial report, the interest coverage ratio of the company and return on investment is higher. Moreover, the corporate tax rate is high.
In context of the above case:

- As a financial manager of the company, which source of finance will you opt for debt or equity, to raise the required amount of capital? Explain by giving any two suitable reasons in support of. your answer.
- Why are the shareholder's of the company like to gain from the issue of debt by the company?

Answer:

- As a financial manager of the company, I will opt for debt to raise the required amount of capital.
I support my decision by giving the following reasons:
    - **Interest coverage ratio:** The interest coverage ratio of the company is high so it can easily meet its fixed commitment of payment of interest and repayment of capital.
    - **Tax rate:** The tax rate is high which makes debt relatively cheaper as the amount of interest paid on debt is treated as a tax deductible expense.
- The shareholders of the company are likely to gain from the issue 6f debt by the company because the return on investment is higher. It helpS a company to take advantage of trading on equity to increase the earnings per share.

Question 3.

Computer Tech Ltd.,is one of the leading information technology outsourcing services providers in India. The company provides business consultancy and outsourcing services to its clients. Over the past five years the company has been paying dividends at high rate to its shareholders. However, this year, although the earnings of the company are high, its liquidity position is not so good. Moreover, the company plans to undertake new ventures in order to expand its business.
In context of the above case: .

- Give any three reasons because of which you think Computer Tech Ltd. has been paying dividends at high rate to its shareholders over the past five years.
- Comment upon the likely dividend policy of the company this year by stating any two reasons in support of your answer.

Answer:

- Computer Tech Ltd. has been paying dividends at high rate to its shareholders over the past five years because of the following reasons:
    - **Earnings:** The earnings of the company have been high. Since the dividends are paid out of current and past earnings, there is a direct relationship between the amount of earnings of the company and the rate at which it declares dividend .

- **Cashflow position:** The cash flow position of the company must have been good as in order to pay high dividends, more cash is required.
- **Access to capital market:** Because of its credit worthiness, the company enjoyed an easy access to capital market. Therefore, it did not feel the need to depend entirely on retained earnings to meet its financial needs. Hence, it declared higher dividends in past.

- This year the company is likely to follow a conservative dividend policy because of the following reasons:
    - The cash flow position of the company is not good and dividends are paid in cash.
    - The company may like to retain profits to finance its expansion projects. Retained profits do not involve any explicit cost and are considered to be the cheapest source of finance.

Question 4.

Bhuvan inherited a very large area of agricultural land in Haryana after the death of his grandfather. He plans to sell this piece of land and use the money to set up a small scale paper factory to manufacture all kinds of stationary items from recycled paper. Being an amateur in business, he decides to consult his friend Subhash who works in a financial consultancy firm. Subhash helps him to prepare a blue print of his future business operations on the basis of sales forecast in next five years. Based on these estimates, he helps Bhuvan to assess the fixed and working capital requirements of business.
In context of the above case:

- Identify the type of financial service that Subhash has offered to Bhuvan.
- Briefly state any four points highlighting the importance of the type of financial service
identified in part (1).

Answer:

- Financial planning is the type of financial service that Subhash has offered to Bhuvan.
- The four points highlighting the importance of financial planning are as follows:

- It ensures smooth running of a business enterprise by ensuring availability of funds at the right time.
- It helps in anticipating future requirements of a funds and evading business shocks and surprises.
- It facilitates co-ordination among various departments of an enterprise like marketing and production functions, through well-defined policies and procedures.
- It increases the efficiency of operations by curbing wastage of funds, duplication of efforts, and gaps in planning.

Question 5.

'Madhur Milan' is a popular online matrimonial portal. It seeks to provide personalized match making service. The company has 80 offices in India, and is now planning to open offices in Singapore, Dubai and Canada to cater to its customers beyond the country. The company has decided to opt for the sources of equity capital to raise the required amount of capital.
In context of the above case:

- Identify and explain the type of risk which increases with the higher use of debt.
- Explain briefly any four factors because of which you think the company has decided to opt for equity capital.

Answer:

- Financial risk of the company increases with the higher use of debt. This is because issue of debt involves fixed commitment in terms of payment of interest and repayment of capital. Financial risk refers to a situation when a company is unable to meet its fixed financial charges.
- The factors because of which the company has decided to opt for equity capital are as follows:
    - **Capital market conditions:** The state of capital market is bullish, so people are likely to invest more in equity.
    - **Fixed operating cost:** The fixed operating cost of company is high so it cannot take the further burden fixed commitment in terms of payment of interest and repayment of capital by issuing debt.
    - **Cashflow position:** The cash flow position of the company is weak so it cannot meet the fixed obligations involved in issue of debt.

- **Risk:** The proportion of debt in its capital structure is already high so it cannot issue further debt, thereby endangering the solvency of the company.

Question 6.
Wooden Peripheral Pvt. Ltd. is counted among the top furniture companies in Delhi. It is known for offering innovative designs and high quality furniture at affordable prices. The company deals in a wide product range of home and office furniture through its eight showrooms in Delhi. The company is now planning to open five new showrooms each in Mumbai and Bangalore. In Bangalore it intends to take the space for the showrooms on lease whereas for opening showrooms in Mumbai, it has collaborated with a popular home furnishing brand, 'Creations.'

- Identify the factors mentioned in the paragraph which are likely to affect the fixed capital requirements of the business for opening new showrooms both in Bangalore and Mumbai separately,
- "With an increase in the investment in fixed assets, there is a commensurate increase in the working capital requirement." Explain the statement with reference to the case above.

Answer:

- The fixed capital requirements of Wooden Peripheral Pvt. Ltd. for opening new showrooms in Bangalore will be relatively less as its taking space on lease, so only rentals have to be paid.
  Similarly, its fixed capital requirement for opening showrooms in Mumbai will be reduced as its going to share the costs with another company through collaboration.
- It's true that," With an increase in the investment in fixed assets, there is a commen¬surate increase in the working capital requirement." Like in the above case, Wooden Peripheral Pvt. Ltd. is planning to invest in new showrooms. Consequently, its requirement of working capital will increase as it will need more money to stock goods, pay electricity bills and salaries to staff. Also, it intends to take the space for the showrooms in Mumbai on lease so it will have to pay rentals.

Question 7.
'Apparels' is India's second largest manufacturer of branded Lifestyle apparel. The company now plans to diversify into personal care segment by launching perfumes, hair care and skin are products. Moreover, it is planning to open ten

exclusive retail outlets in various cities across the country in next two years.
In context of the above case:

- Identify the two factors affecting the fixed capital needs of the company by quoting lines from the paragraph.
- Why is the management of fixed capital considered to be an important for a business?

Answer:

- The factors affecting the fixed capital needs of the company are as follows:
  - **Diversification:** If a business enterprise plans to diversify into new product lines, its requirement of fixed capital will increase.
  - **Growth prospects:** If a business enterprise plans to expand its current business operations in the anticipation of higher demand, consequently, more fixed capital will be needed by it.
- The management of fixed capital is considered important because:
  - It affects the growth and profitability of business in future.
  - It involves huge investment outlay in terms of investment in land, building, machinery etc.
  - It influences the overall level of business risk of the organisation.
  - If these decisions are reversed, they may lead to major losses.

Question 8.
After persuing a course in event management, Kajal and her brother Kamal promoted an event management company under the name Khushi Entertainment Private Limited. They strive together as dedicated and dynamic professionals managing different kinds of formal and informal events across all major cities in India and abroad. They design the event idea and co-ordinate the different aspects of the event to make it a grand success. As a policy, they take fifty percent of the payment as advance from the client before the start of an event and receive the balance charges after the successful completion of the event.
In context of the above case:

- Comment upon the working capital needs of the company keeping in mind its nature of business.

- Identify the other factor mentioned in the paragraph which is likely to affect the working capital requirement of their business.

Answer:

- The working capital requirements of Khushi Entertainment Private Limited will be relatively less as they are engaged in providing event management services, wherein there is no need to maintain inventory
- The other factor mentioned in the paragraph which is likely to affect the working capital requirement of their business is ‘Credit availed.’ Since as a policy, they take fifty percent of the payment as advance from the client before the start of an event, their requirement of working capital is reduced.

Question 9.

Storage Solution Ltd. is a large warehousing network company operating. through a chain of warehouses at 40 different locations across India. The company now intends to undertake computerisation of its owned ware houses as it seeks to provide better value added and cost effective solutions for scientific storage and preservation services to the market participants dealing in agricultural products including farmers, traders, etc.
In context of the above case:

- How is the decision to undertake computerisation of owned warehouses likely to affect the fixed capital requirements of its business?
- Name any two sources that company may use to finance the implementation of this plan.

Answer:

- The decision to undertake computerisation of owned warehouses will increase the fixed capital requirements of its business both in present and future as after sometime, the technology being used will become obsolete and need upgradation.
- The company may use retained earnings and take loans from financial institutions to implement this plan.

Question 10.

Visions Ltd. is a renowned multiplex operator in India. Presently, it owns 234 screens in 45 properties at 20 locations in the country. Considering the fact that the there is a growing trend among the people to spend more of their

disposable income on entertainment, two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains etc. It had then floated an initial public offer of equity shares in order to raise the desired capital. The issue was fully subscribed and paid. Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend and the market price of its shares has increased manifolds.
In context of the above case:

- Name the different kinds of financial decisions taken by the company by quoting lines from the paragraph.
- Do you think the financial management team of the company has been able to achieve its prime objective? Why or why not? Give a reason in support of your answer.

Answer:

- The different kinds of financial decisions taken by the company are as follows:
  - **Investment decision:** "Two years back the company had decided to add more screens to its existing set up and increase facilities to enhance leisure, food chains etc."
  - **Financing decision:** "It had then floated an initial public offer of equity shares in order to raise the desired capital."
  - **Dividend decision:** "Over the years, the sales and profits of the company have increased tremendously and it has been declaring higher dividend."
- Yes, the financial management team of the company has been able to achieve its prime objective i.e. wealth maximisation of the shareholders by maximising the market price of the shares of the company.

Question 11.

After completing his education in travel and tourism, Arjun started Travel Angels Pvt. Ltd. along with his twin brother Bheem. Their company seeks to provide travel solutions to its clients like ticket booking for airways, railways and road ways, hotel booking, insurance etc. Although the business is doing well both of them have realised that they are not good in managing finance, and feel confused and frustrated sometimes due to financial crises that may suddenly arise. In order to avoid such situations in the future, they hire Nakul and Sehdev as financial managers, who have done a degree certification

course in financial management.
In context of the above

- Give the meaning of financial management.
- Outline the role of Nakul and Sehdev as the financial management team of the Travel Angels Pvt. Ltd. by giving any four suitable points.

Answer:

- Financial Management is concerned with optimal procurement as well as usage of finance.
- Nakul and Sehdev will play a very important role as the financial management team of the Travel Angels Pvt. Ltd. in managing the financial health of the company:
    - To determine the capital requirements of business both long-term and short term.
    - To determine the capital structure of the company and determine the sources from where required capital will be raised keeping in view the risk and return matrix.
    - To ensure efficient management of cash in order to ensure both liquidity and profitability.
    - To exercise overall financial control in order to promote s'afety, profitability and conservation of funds.

Question 12.
Wireworks Ltd. is a company manufacturing different kinds of wires. Despite fierce competition in the industry, it has been able to maintain stability in its earnings and as a policy, uses 30% of its profits to distribute dividends. The small investors are very happy with the company as it has been declaring high and stable dividend over past five years.
In context of the above case:

- State any one reason because of which the company has been able to declare high dividend by quoting line from the paragraph.
- Why do you think small investors are happy with the company for declaring stable dividend?

Answer:

- Stability in earnings: The company has been able to declare high dividend because its earnings are stable.
  "Despite fierce competition in the industry, it has been able to maintain stability in its earnings."
- The small investors are happy with the company for declaring stable dividend as they enjoy a regular income on their investment.

Question 13.

Manoj is a renowned businessman involved in export business of leather goods. As a responsible citizen, he chooses to use jute bags for packaging instead of plastic bags. Moreover, on the advice of his friends, he decides to use jute for manufacturing aesthetic handicrafts, keeping in view the growing demand for natural goods. In order to implement his plan, after conducting a feasibility study, he decides to set up a separate manufacturing unit for producing varied jute products.
In context of the above case:

- Identify the type of investment decision taken by Manoj by deciding to set up a separate manufacturing unit for producing jute products.
- State any two factors that he is likely to consider while taking this decision

Answer:

- Capital budgeting decision has been taken by Manoj.
- The factors affecting Capital Budgeting Decision are as follows:
  - **Cash inflows:** The expected cash inflows from the proposed projects should be carefully analysed and the project indicating higher cash inflows should be selected.
  - **Rate of return:** The expected rate of return should be carefully studied in terms of risk associated from the proposed project. If two projects are likely to offer the same rate of return, the project involving lesser risk should be selected.

Question 14.

Khoobsurat Pvt. Ltd. is the largest hair salon chain in the Delhi, with over a franchise of 200 salons. The company is now planning to set up a manufacturing unit in Faribadad for production of various kinds of beauty products under its own brand name.
In context of the above case:

- Comment upon the fixed capital needs of the company.
- How will the requirement of fixed capital of the company change when it implements its plan to set up a manufacturing unit?

Answer:

- The fixed capital needs of the company are low as its salons have been promoted in the form of franchises.

Sources	**Situation 1** **Amount (in Rs.)**	**Situation 2** **Amount (in Rs.)**
Equity shares	90,00,000	90,00,000
10 % Debentures	NIL	40,00,000
Total Capital	90,00,000	1,30,00,000
EBIT	13,50,000	19,50,000
Less: Interest	—	– (4,00,000)
EBT	13,50,000	15,50,000

Less: Tax @ 30%	– (4,05,000)	– (4,65,000)
EAT	9,45,000	10,85,000
No. of shares of Rs. 10 each	9,00,000	9,00,000
EPS	9,45,000/9,00,000 = 1.05	10,85,000/9,00,000 = 1.21

- The requirement of fixed capital of the company will increase when it implements its plan to set up a manufacturing unit because it will have to make investments in buying land, building, machinery etc.

Question 15.

Well-being Ltd. is a company engaged in production of organic foods. Presently, it sells its products through indirect channels of distribution. But, considering the sudden surge in the demand for organic products, the company is now inclined to start its online portal for direct marketing. The financial managers of the company are planning to use debt in order to take advantage of trading on equity. In order to finance its expansion plans, it is planning to ‘ raise a debt capital of Rs. 40 lakhs through a loan @ 10% from an industrial bank. The present capital base of the company comprises of Rs. 9 lakh equity shares of Rs. 10 each. The rate of tax is 30%.
In the context of the above case:

- What are the two conditions necessary for taking advantage of trading on equity?
- Assuming the expected rate of return on investment to be same as it was for the current year i.e. 15% , do you think the financial managers will be able to meet their goal. Show your workings clearly.

Answer:

- The two conditions necessary for taking advantage of trading on equity are :
    - The rate of return on investment should be more than the rate of interest.
    - The amount of interest paid should be tax deductible.
-

Yes, the financial managers will be able to meet their goal as the projected EPS, with the issue of debt, is higher than the present EPS